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EXPOSURE DRAFT

DECEMBER 20, 1971

Proposed APB Opinion

Translating Foreign Operations

This draft Opinion deals with some aspects of accounting for translation adjustments arising from the application of the monetary/nonmonetary approach to the translation of foreign currency assets and liabilities. Among other things it proposes that certain debit and credit translation adjustments should be deferred while others should be carried immediately to income.

Issued by the Accounting Principles Board of the American Institute of Certified Public Accountants for Comment from Persons Interested in Financial Reporting

Comments should be received by January 19, 1972 and addressed to Richard C. Lytle, Administrative Director, APB at the Institute's Offices, 666 Fifth Avenue, N.Y., N.Y. 10019

INTRODUCTION

1. In August 1971 the U. S. Government suspended convertibility of the dollar into gold or other reserve assets, causing the abandonment of fixed exchange ratios between the dollar and other currencies. The earlier actions of the German and Netherlands governments in permitting their currencies to "float" in May 1971 and the concurrent revaluation by Switzerland are considered a part of the abandonment of fixed exchange ratios in relation to the dollar. To date, the "floating" of exchange rates has resulted in a weakening in the exchange value of the dollar in relation to many other currencies even though the dollar has not been officially devalued in relation to gold.

2. An Accounting Research Study[1] is nearing completion and will provide a basis for future deliberations by the Board on the broad subject of translation of foreign currency financial statements. At a later date the Board will consider all aspects of accounting for foreign operations and the settlement of balances receivable and payable in a foreign currency.

3. Translation is required with respect to financial statements of foreign branches for combination with the head office, of foreign subsidiaries for inclusion in consolidated financial statements of the parent, and of foreign investee companies accounted for by the equity method. In practice there are two approaches to translation which are generally accepted. These are the current/noncurrent approach and the monetary/nonmonetary approach.

4. *Current/noncurrent approach.* The current/noncurrent approach follows generally the procedures in Chapter 12 of ARB No. 43 and, in brief, provides for the translation of (a) current assets (except inventory in many situations) and current liabilities at the rate of exchange at the balance sheet date (current rate) and (b) plant and equipment, permanent investments, long-term receivables, inventory in many situations, long-term liabilities and capital stock at the rates of exchange prevailing when the assets were acquired or constructed and when liabilities were incurred and capital stock issued (historical rate). Thus, losses or gains are measured only by reference to changes in the current rate of exchange applied to current assets and current liabilities. Chapter 12 requires provision by charge against income for such losses. It also expresses preference for carrying such gains to a suspense account.

5. Some companies that have followed this approach have substantial plant and equipment and long-term liabilities in countries whose currencies have strengthened recently in relation to the dollar. There will be no immediate effect from the translation of noncurrent assets and noncurrent liabilities at the historical rates of exchange. The effect on subsequent periods is a matter of the timing of the liquidation of long-term liabilities in relation to the amortization of noncurrent assets.

6. *Monetary/nonmonetary approach.* The amendment to Chapter 12 by paragraph 18 of APB Opinion No. 6 recognized widespread application of the monetary (current rate) and nonmonetary (historical rate) approach. Assets and liabilities are called "monetary" if their amounts are fixed by contract or otherwise in terms of the currency of the foreign entity. Examples of monetary assets and liabilities are cash, accounts and notes receivable in cash, and accounts and notes payable in cash. Examples of nonmonetary items are inventories, investments in common stocks, property, plant, and equipment, deferred charges which represent costs expended in the past, advances received

[1] Accounting Research Studies are not pronouncements of the Board or of the Institute but are published for the purpose of stimulating discussion on important accounting matters.

on sales contracts, liabilities for rent collected in advance, deferred credits which represent reductions of prior expense, and common stock.

7. In practice, most companies have charged or credited income with translation adjustments arising from application of the monetary/nonmonetary approach. Some companies deferred credit translation adjustments developed by this approach in situations where the foreign currency has weakened in relation to the home currency. They preferred to await experience to demonstrate that the plant and equipment, which were translated at the historical rates (and thus the dollar equivalent was not reduced), can be employed to produce a product which will sell in an appropriate market for a selling price (usually an increase is necessary) sufficient to cover the historical dollar depreciation charges on plant and equipment that must be absorbed in future operations.

8. *Translation adjustment considerations.* When a new exchange rate is applied in the translation of assets and liabilities of a foreign entity, a translation adjustment results from reflecting the difference between the old and new rates. It has become common to refer to debit translation adjustments as "losses" and credit translation adjustments as "gains". Under either of the approaches described above, the translation process involves adjustments to only monetary assets and monetary liabilities. Whether credit adjustments are always gains has been questioned frequently in the past, particularly with respect to currencies which have weakened in relation to the dollar. Only occasionally have debit adjustments been questioned as to whether they are in fact losses when currencies have strengthened in relation to the dollar.

9. Recent events clearly demonstrate that the U. S. dollar is not stable in relation to many foreign currencies and the question has arisen as to whether all debit translation adjustments are losses. Some hold that they all are in fact losses and thus should be charged to income immediately. Others believe it is unreasonable to assume, without further analysis of each case, that a U. S. enterprise investing in a foreign operation has, in fact, always incurred a loss at a time when in their view the exchange value of many foreign currencies has turned in favor of the U. S. investor.

10. In the current situation, the floating of exchange rates has not generally been viewed as an event giving rise to an economic loss as to a foreign operation located in a country whose currency has strengthened in relation to the U. S. dollar. It has been contended that the upward revaluation of the foreign currency in relation to the U. S. dollar does not of itself represent a diminution in the value of the investment in the foreign operation in terms of U. S. dollars. In many instances, the floating of a currency is not expected to alter the foreign currency cost of materials or labor or foreign currency selling prices. Thus, the expectation is that profits *in foreign currency* would continue at the same level as in the past. The U. S. dollar equivalent of the subsequent profits, however, would in such instances be higher than in the past. If the foreign operation makes its purchases of materials in dollars, the benefit of the floating of the currency may be even greater. Consequently, it has been contended that it is unrealistic to record a current loss when a debit translation adjustment arises from applying the monetary/nonmonetary approach to situations where long-term foreign currency borrowings are outstanding. Under these circumstances, a more accurate matching of revenues and expenses is thought to be accomplished by deferring a debit translation adjustment for amortization to future periods than by charging it to income immediately.

11. There are different views as to how the amount to be deferred should be determined and the basis upon which it should be amortized. Many believe the amount to be deferred should be determined by reference to long-term monetary liabilities on the grounds that it is those liabilities which give rise to the portion of the adjustment which is properly associated with future revenues. For this purpose, the amount deferred is based on the net aggregate amount of all translation adjustments, whether debit or credit.

12. Some believe the amount to be deferred should be determined by reference to nonmonetary assets and it should be taken into income by reference to introduction of such assets into the income statement as cost of goods sold and depreciation. To them, the need for deferral is a result of the convention of translating nonmonetary items at historical rates and measurement of the deferral should be based on such items. Those who hold this view would not aggregate all translation adjustments but would analyze each situation separately.

OPINION

13. The Board believes some modification of the accounting for translation adjustments arising from the application of the monetary/nonmonetary approach to the translation of foreign currency assets and liabilities is required. Therefore, the Board has concluded that when:

Monetary liabilities exceed monetary assets

- If foreign currency long-term monetary liabilities are present, the net translation adjustment (debit or credit) should be deferred to the extent it does not exceed the adjustment resulting from the change in the exchange rate used to translate those long-term liabilities at the close of the period at the new current rate. The amount deferred should be amortized over the remaining term of the long-term liabilities by use of the interest method.[2] Any remainder of the translation adjustment should be taken into income currently.
- If no long-term monetary liabilities are present, all of the translation debit or credit adjustment should be taken into income currently.

Monetary assets exceed monetary liabilities

- All of the translation debit or credit adjustment should be taken into income currently.

14. The procedures described in the preceding paragraph should be applied to each entity included in combined or consolidated financial statements. However, intercompany balances (including companies accounted for by the equity method) should be eliminated in determining the net monetary position. The debit or credit amounts deferred should be aggregated and netted against each other. The net amount of the charges and credits to income should be determined. A net credit to income should be applied to reduce a net deferred debit balance and a net charge to income should be applied to reduce a net deferred credit balance. No adjustment to the aggregate of the individual entities' results is required when the net deferral is a charge and there is a net charge to income or when the net deferral is a credit and there is a net credit to income. The amortization of the resulting deferrals is determined in subsequent years after those years' year end adjustments (as described above) have been ascertained. Such amortiza-

[2] See paragraph 16 of APB Opinion No. 12, *Omnibus Opinion—1967,* for a description of the interest method.

tion should not be treated as an extraordinary item.

15. Results obtained from the application of the foregoing procedures should be carefully reviewed to determine their appropriateness in the circumstances. This is also desirable where the current/noncurrent approach is applied. For example, credits to income arising from translation may be inappropriate if it appears that reversals in subsequent years may be imminent or that other impairments are evident.

Accounting policies and accounting changes

16. A company should disclose its accounting policies as to the determination of and accounting for foreign exchange transaction gains and losses. The disclosure should cover such matters as (a) whether the current or historical rate is used in translating long-term receivables and long-term liabilities and (b) the amount of the translation adjustment recognized currently and the amount deferred. A company should apply the same approach to each individual entity included in the combined or consolidated financial statements.

17. A company previously describing its policies along the lines of the monetary/nonmonetary approach is not considered to have made a change in accounting principle in adopting this Opinion if it has previously deferred translation adjustments. If the company has not previously deferred translation adjustments, the adoption of this Opinion is a change in accounting principle to be applied currently and prospectively and the company should not retroactively restate prior periods or report the change as described in paragraph 19 of APB Opinion No. 20, *Accounting Changes.* However, in these cases debit translation adjustments related to long-term liabilities should not be deferred until credit adjustments relating to the balance of the same liabilities which were taken into income as "gains" in prior periods have been offset. These amounts should be charged to income as such debit translation adjustments arise subsequent to the adoption of this Opinion.

18. A company that had a policy (say, evidenced by translations for a subsidiary in England at the time of the devaluation of the pound sterling in 1967) of applying the current rate in translating long-term receivables and long-term liabilities would have a change in accounting principle if it now applies the historical rate for these translations. This would be a change in accounting principle from the monetary/nonmonetary approach to the current/noncurrent approach. APB Opinion No. 20 should apply for such a change in a fiscal year beginning after July 31, 1971 (the effective date of the Opinion) and the change should be reported as described in paragraph 19 of that Opinion. On the other hand, a change from the current/noncurrent approach to the monetary/nonmonetary approach (including the procedures described in this Opinion) should be considered a change in accounting principle to be applied currently and prospectively.

Extraordinary items

19. The German, Swiss and Netherlands currencies "floated" as early as May 1971, but for most currencies August 16, 1971 is considered the start of a revaluation period. The length of time required to complete the major revaluation is indeterminate at this time but for the purpose of determining an extraordinary item it should be regarded as extending to the earlier of the date new parities are set in the future or (a date will be inserted when the Opinion is issued).

20. To the extent translation adjustments are not deferred, the effect on

income of cumulative changes in foreign exchange rates occurring during the revaluation period would ordinarily qualify foreign translation gains or losses as extraordinary under the criteria in paragraphs 21 and 22 of APB Opinion No. 9. A company translating the financial statements of several foreign entities should report the aggregate effect of the revaluation as an extraordinary net gain or net loss. Care should be taken not to include as an extraordinary item those gains and losses resulting from changes in exchange rates of some currencies which have continued to deteriorate during this period in relation to the dollar as was expected.

21. Regardless of size, gains or losses from foreign exchange fluctuation (not a major devaluation or an upward revaluation) occurring prior to or subsequent to this revaluation period do not constitute extraordinary items (see paragraph 22 of APB Opinion No. 9).

EFFECTIVE DATE

22. Paragraphs 13, 14, and 17 of this Opinion apply only to companies using the monetary/nonmonetary approach. The remainder of the Opinion applies to all companies having foreign operations. It is effective for fiscal periods beginning after December 31, 1971. However, the Board encourages earlier application of the provisions of this Opinion. The effect of the floating of the dollar during the revaluation period may give rise to an extraordinary item as described in paragraph 19.

NOTES

Opinions of the Accounting Principles Board present the conclusions of at least two-thirds of the members of the Board, which is the senior technical body of the Institute authorized to issue pronouncements on accounting principles.

Board Opinions are considered appropriate in all circumstances covered but need not be applied to immaterial items.

Covering all possible conditions and circumstances in an Opinion of the Accounting Principles Board is usually impracticable. The substance of transactions and the principles, guides, rules, and criteria described in Opinions should control the accounting for transactions not expressly covered.
actions not expressly covered.

Unless otherwise stated, Opinions of the Board are not intended to be retroactive.

Council of the Institute has resolved that Institute members should disclose departures from Board Opinions in their reports as independent auditors when the effect of the departures on the financial statements is material or see to it that such departures are disclosed in notes to the financial statements and, where practicable, should disclose their effects on the financial statements (Special Bulletin, *Disclosure of Departures from Opinions of the Accounting Principles Board,* October 1964). Members of the Institute must assume the burden of justifying any such departures.

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